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Scholastic Books Faces State Tax Overreaching

By

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Introduction

For decades, American schoolchildren have purchased books and other educational materials from Scholastic Book Club, Inc., which seeks to foster good reading habits and complement classroom education. However, courts in two states (Connecticut and Tennessee) have ruled this year that Scholastic owes back sales and use taxes, despite the fact that the company has neither property nor employees in those states, potentially disrupting Scholastic's mission.

The Scholastic cases reflect the ongoing debate about state tax authority, and the need for clearer rules on the proper extent of a state's power to impose tax obligations on out-of-state companies.

The Proper Scope of State Power to Tax: Physical Presence vs. Economic Presence

There exist two competing views of when states may properly assert the power to tax: physical presence nexus and economic presence nexus. Physical presence nexus means that the state can assert the power to tax on any individual or business that has a real, tangible presence in a state, such as with the presence of property or employees. Economic presence nexus proponents believe that states should have the power to tax any company that has customers in the state from which the company derives income.¹ Multistate companies, catalog sellers, and online retailers are the businesses most likely to be tripped up by unclear nexus rules.

While both presence standards have been argued before many courts, physical presence has evolved as the stronger standard. This can be attributed to the clarity of the argument: if a business is located in a jurisdiction, then it is liable for a tax. Economic nexus is difficult to know in advance because a company's out-of-state customers must demonstrate enough of a link to act as though the company were located in that

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¹ See Chris Atkins, *Does the Commerce Clause Protect Commerce or State Cooffers?*, TAX FOUNDATION TAX POLICY BLOG (Dec. 12, 2006), <http://www.taxfoundation.org/news/show/2083.html>.

area. However, as states increasingly seek to tax nonresidents, especially for Internet transactions, they are pushing for judicial adoption of the economic nexus standard.²

The U.S. Supreme Court has ruled on the tax treatment of remote sellers in key cases that frame the debate over Scholastic. The Court ruled in *Scripto, Inc. v. Carson* (1960) that a Georgia-based retailer (Scripto) had physical presence in Florida despite having no employees or property in that state. The Court found that Scripto's independent contractors were effectively salesmen and that their activities conducted on Scripto's behalf were more important than the fact that the contractors were not technically employees of Scripto.³

Scripto's rule—deeming independent contractors to be employees where their activities are essential for the maintenance of the out-of-state company's market in the state—is widely considered to be the furthest recognized extension of a state's taxing power. The Connecticut court did not limit its ruling to the confines of this rule, however, and actually suggested that their rule necessarily goes beyond *Scripto*: “[*Scripto*] was not necessarily intended to mean that a substantial nexus between the out-of-state retailer in the state could not be found in other, as of yet undefined circumstances.”⁴

In *National Bellas Hess, Inc. v. Ill. Dept. of Revenue* (1967) and *Quill Corp. v. North Dakota* (1992), the U.S. Supreme Court affirmed the physical presence nexus standard for determining sales tax collection obligations of out-of-state retailers. Bellas Hess was a mail order company, incorporated in Delaware, that distributed catalogs to customers who would return order forms and then receive their items via common carrier. Illinois argued that any company soliciting customers in the state must collect sales tax but the Court rejected that approach. Finding that Bellas Hess had no physical presence in Illinois, they ruled no collection obligation existed. *Quill* reaffirmed this rule after North Dakota enacted a law similar to the one struck down in *National Bellas Hess*.

Connecticut Court: Teachers are Both Customers and Salespeople

In March, Connecticut's state supreme court ruled that Scholastic is “physically present” in the state for tax collection purposes despite having no property or employees there.

Two issues allowed physical presence to be established: (1) how books and products were distributed and (2) the role of those distributors. Scholastic Inc. is the parent company, based in Missouri, and makes educational products available through direct purchase or in retail stores. Scholastic Book Club (SBC) is a subsidiary that operates entirely through schools. SBC sends catalogs to voluntarily participating school teachers who can give them to their students. The students then give the catalogs or flyers to their parents, who may choose to purchase items and give the order back to the teacher. The teacher submits a bulk order to Scholastic and receives the items via common carrier (such as the U.S. mail or a private delivery service).

² See generally Joseph Henchman, *Why the Quill Physical Presence Rule Shouldn't Go the Way of Personal Jurisdiction*, 46 STATE TAX NOTES 387 (2007).

³ See Chris Atkins, *Important Tax Cases: Scripto v. Carson and the Agency Theory of Nexus*, Tax Foundation Tax Policy Blog (Aug. 25, 2006), <http://taxfoundation.org/blog/show/1031.html>.

⁴ Carroll Waltreese, “Tax Professionals Split on Constitutionality of Scholastic Cases,” TAX ANALYSTS (Apr. 24, 2012).

The catalog explicitly says that there is no agency relationship between the teacher and Scholastic.⁵ While the teacher receives no monetary remuneration for collecting the sales from the parents, there is a bonus point system based on the number of books ordered each month. Teachers can earn points and redeem them for books or other items restricted to classroom use.

In 2007, the Connecticut Department of Revenue asserted that SBC must collect sales and use taxes on books sold in the state. Out-of-state businesses, however, are generally exempt from this obligation, and SBC does not own or lease any property, have employees, possess a phone or web address, or have a bank account in Connecticut. Revenue officials argued that teachers were operating as representatives of SBC and thus were effectively employees.

In 2009, the trial court ruled against the state: “As the teachers are not in-state ‘order-takers’ seeking to produce ‘revenue’ for themselves or SBC, the court concludes that Connecticut schoolteachers are not ‘representatives’ of SBC.”⁶ To have nexus in a state, a company must have a minimum link and the trial court did not believe the teachers as “representatives” argument established that link.

In its May decision, the Connecticut Supreme Court overruled the trial court and found it persuasive that teachers are the sole conduit for purchase and communication between SBC and the children’s parents. While the court did recognize that teachers are also customers of SBC, they concluded that teachers could be both SBC customers and representatives. They pointed to teachers distributing flyers and catalogs of Scholastic products, collecting money for purchase, and mediating problems of sale. The final decision rested on redefining what constitutes a representative:

A representative is a person who is not an employee or an agent and who does not necessarily act through delegated authority for remuneration, as does a salesman, canvasser or solicitor, but who otherwise stands in the place of, or acts on behalf of, the out-of-state retailer “for the purpose of selling, delivering or taking orders” for the retailer’s products.⁷

Some 14,000 teachers in Connecticut use SBC programs. Because Connecticut now deems all these individuals to be SBC representatives, the company must pay more than \$3 million in back sales taxes and penalties. Connecticut’s broad interpretation of “representative” moves away from the certainty of a bright line between “employee” and “non-employee.” An independent representative that delivers or takes orders for a product can now establish nexus for the remote seller. In this case, educational products are being targeted but this precedent could theoretically be applied to any out-of-state company.

⁵ Grant Thornton LLP, *Connecticut Supreme Court Holds Teachers Created Sales Tax Nexus for Out of State Book Distributor*, (Apr. 3, 2012), http://www.grantthornton.com/staticfiles/GTCom/Tax/SALT_Alert_files/SALT_Alert_CT_nexus_books.pdf.

⁶ *Scholastic Book Clubs, Inc. v. Commissioner of Revenue Services*, 2009 WL 1175675 (Conn. Super. Apr. 9, 2009).

⁷ *Scholastic Book Clubs, Inc. v. Commissioner of Revenue Services*, 38 A.3d 1183, 1190 (Conn. 2012).

Tennessee Rule and Other States

Earlier in 2012, the Tennessee Court of Appeals also ruled against Scholastic, holding that the company owes over \$5 million in back taxes and penalties.⁸ There, the court set aside the question of whether the teachers are Scholastic agents, instead focusing on the fact that SBC effectively created a sales force through its teachers, thus developing a market in the schools. The court noted that SBC was using taxpayer services (public schools) to solicit and deliver its products, which demonstrates a benefit from collecting the sales tax.

The extent to which the Tennessee court decision rests on Scholastic's benefit from its sales in the state is problematically expansive. The opinion's discussion of Scholastic creating a market in the state is on firmer ground, but does not directly conclude that the teachers' activities amount to employee-like activity. An appeal to the Tennessee Supreme Court is pending.

Earlier state cases further illustrate this issue:

- The California Court of Appeals ruled in *Scholastic Book Clubs, Inc. v. State Board of Equalization* (1989) that Scholastic had an obligation to collect tax because the teachers were SBC agents due to their activities in the SBC business operation and their remuneration with bonus points.⁹
- The Kansas Supreme Court in *Appeal of Scholastic Book Clubs, Inc.* (1996) reached a similar result: "By Scholastic's accepting orders and payments and shipping merchandise to teachers for distribution to the student purchasers, the Kansas teachers are the implied agents of Scholastic."¹⁰
- The Michigan Court of Appeals went the other way in *Scholastic Book Clubs Inc. v. Michigan State Department of Treasury Revenue Division* (1997). The Court found that "[t]he teachers are not a sales force that works for plaintiff. Rather, they are analogous to parents who order an item from a mail-order catalog for their children; no one would seriously argue that such parents are a "sales force" for mail-order vendors."¹¹

The Future for Scholastic and Other Retailers

States are becoming increasingly aggressive about expanding nexus standards beyond their borders as budgets get tighter and the desire to find new revenue increases. Moreover, the precedent thus far in these *Scholastic* cases suggests a bleak future for remote sellers seeking to do business across state lines. With over 9,600 sales tax jurisdictions in the United States, each with a parochial and bewildering set of rates, rules, and bases, it is difficult for businesses to comply fully with these requirements, particularly since they are becoming less uniform and more complex each year. In *Quill*, the Supreme Court emphasized the importance of clarity to state tax authority and issues of interstate commerce, inviting Congress to substitute an alternative standard to physical presence if it desired.

⁸ *Scholastic Book Clubs, Inc. v. Farr*, 2012 WL 259979 (Tenn. Ct. App. Jan. 27, 2012).

⁹ *Scholastic Book Clubs, Inc. v. State Bd. of Equalization*, 207 Cal.App.3d 734, 740 (Cal. Ct. App. 1989).

¹⁰ *Appeal of Scholastic Book Clubs, Inc.*, 920 P.2d 947, 956 (Kan. 1996).

¹¹ *Scholastic Book Clubs, Inc. v. State, Dept. of Treasury, Revenue Div.*, 567 N.W.2d 692, 696 (Mich. App. 1997).

A number of options exist, from a clear physical presence standard to several congressional proposals that would advance simplification while allowing states to collect additional revenue. Additionally, there are other ideas such as origin-based sales taxes, where the tax would be collected on where the seller is located (as is the case with brick-and-mortar businesses), not where the customer is located. Scholastic, incidentally, is headquartered in Missouri.

The rise of Internet retailers and economic integration generally means the costs of nexus uncertainty are more likely to burden and impede economic growth.¹² The *Scholastic* cases illustrate the inconsistency of courts in deciding state tax authority and the necessity for Congress or the courts to definitively resolve the problem. States' strong desire to shift the burdens of government from the voters and businesses that benefit directly from its services to unrepresented, remote taxpayers can only be checked by congressional or court action.

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¹² Joseph Henchman, Dirk Gisebert, & Laura Lieberman, *Ending the Nexus Guessing Game for Taxpayers: Lamtec Corp. v. Washington Department of Revenue*, TAX FOUNDATION FISCAL FACT NO. 274 (Jun. 16, 2011), <http://www.taxfoundation.org/news/show/27381.html>.